United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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74—1537

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 74-1537

RENEE SLADE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

EDWARD E. ODETTE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT, THIRD-PARTY PLAINTIFF, APPELLANT

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Preliminary Statement

On January 2, 1974, the District Court (Carter, D.J.) denied the motion of defendant, third-party plaintiff, and appellant Shearson, Hammill & Co. Incorporated ("Shearson") for partial summary judgment in these actions.

Shearson sought partial summary judgment on two separate grounds, one factual and one legal. The Court found that an issue of fact precluded summary judgment on the first ground and that summary judgment was not warranted as a matter of law on the second. Shearson moved for certification of the legal ground pursuant to 28 U.S.C. § 1292(b), the District Court certified, and this Court accepted that certification.

Statute Involved

The statute and rule involved in this appeal are Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b), and Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to that Section (17 C.F.R. 240.10(b)-5). These provisions are reproduced at the end of this brief.

Question Presented

In practical effect, the district court held that a securities firm whose investment banking department receives material adverse nonpublic information about an investment banking client must use that information for the benefit of its own retail customers by prohibiting the solicitation of transactions in that stock even though the information is not public. The district court certified the following question for review:

> "Is an investment banker/securities broker who receives adverse material nonpublic information about an investment banking client precluded from soliciting customers for that client's securities on the basis of public information which (because of its possession of inside information) it knows to be false or misleading?"

Statement of the Case

The Nature of the Case

Plaintiff's seek money damages and/or equitable relief for violation of the federal securities laws, primarily Section 10(b) of the Securities Exchange Act of 1934. Their claims involve the relationship between the investment banking department and broker-dealer or retail sales department of a securities firm when the investment banking department obtains material nonpublic information about an investment banking client; specifically, should the investment banking department withhold the information from all other departments of the firm pending its public disclosure by the client company.

The Course of the Proceedings

Plaintiffs commenced their actions in November of 1972, both seeking to represent a class composed of Shearson customers who purchased the common stock of Tidal Marine International Corporation ("Tidal Marine" or "Tidal") and whose purchases were solicited by investment executives or registered representatives employed by Shearson. The approximate period covered by these classes is the last quarter of 1971 and the first half of 1972. During most of this period, Shearson was investment banker to Tidal [*Slade* Am. Comp. para. 4, JA at A-3; *Odette* Am. Comp. para. 25, JA at A-71] and allegedly had notice of adverse material nonpublic information about Tidal which was received in its capacity as the company's investment banker. Shearson did not disclose the inside information to its investment executives or its customers. [*Slade* Am. Comp. para. 9, JA at A-4; *Odette* Am. Comp. paras. 33-34, JA at A-73-A-74]. According to the Amended Complaints, Shearson should have used any adverse material, nonpublic information it possessed to prohibit its investment executives from soliciting purchases of Tidal stock. [*Slade* Am. Comp.

paras. 9-10, JA at A-4; *Odette* Am. Comp. paras. 34-35, JA at A-74]. Shearson answered the *Odette* Amended Complaint on December 18, 1972, and the *Slade* Amended Complaint on February 2, 1973, denying all plaintiffs' allegations of wrongdoing. [JA at A-79-A-82; JA at A-6-A-8].

Plaintiff Odette moved for a preliminary injunction requiring defendant Shearson to disclose to plaintiff all material, nonpublic information in its possession. The District Court denied that motion; and when plaintiff appealed, this Court affirmed from the bench at the close of plaintiff's argument.

The District Court ordered the *Slade* and *Odette* cases consolidated, appointed counsel for Slade as general counsel for the plaintiffs in the consolidated actions, and requested general counsel to submit a motion to determine whether the consolidated complaints should proceed as class actions. General counsel moved for an order declaring the two cases to be class actions. Shearson cross-moved to strike the class action allegations and for partial summary judgment. In the motion for partial summary judgment, Shearson argued, as a matter of fact, that it had no adverse material, nonpublic information about Tidal Marine during the period in which the plaintiffs purchased the stock and, as a matter of law, that, even if its investment banking department had inside information, a securities firm cannot use that kind of information for the benefit of its public customers until the information has been publicly disclosed.

On January 2, 1974, the District Court filed a Memorandum Opinion denying both aspects of the motion for summary judgment. [JA at A-49-A-55]. It held that, as a matter of fact, Shearson might have had notice of Tidal Marine's financial difficulties, thus presenting a triable issue of fact [Mem. Op. at 3-4, JA at A-50]; and that, as a matter of law, a securities firm which acquires adverse

nonpublic information in the course of its investment banking activities on behalf of the company must use that information to prohibit solicitation of purchases in that stock by the firm's public customers. [Mem. Op. at 4-7, JA at A-51-A-52].

Shearson sought an order in the district court certifying the question of law to this court pursuant to 28 U.S.C. § 1292(b). The district court certified, holding that the question was one of first impression which had far-reaching ramifications for the structure of the securities industry. [Mem. Op. on Cert., pp. 4-6, JA at A-58-A-59]. Shearson petitioned this Court for leave to appeal the certified question and this Court granted the petition.

Statement of Facts

Shearson is a Delaware corporation engaged in the securities business as both an investment banker and a broker-dealer. The Corporate Finance Department of Shearson performs the firm's investment banking functions, and the Retail Sales Organization handles broker-dealer transactions for the firm's public customers. [Bogardus Aff. paras. 3-4, JA at A-26-A-27].

In the course of its investment banking function, the Corporate Finance Department deals regularly with its investment banking clients and, from time to time, learns adverse material, nonpublic information about them. Pursuant to Shearson's internal policies and procedures, the Corporate Finance Department is prohibited from releasing any information about its investment banking clients to the Retail Sales Organization and the firm's public customers until the information is made publicly available by the company. [Bogardus Aff. paras. 5-6, JA at A-27].

The Retail Sales Organization is administered separately from the investment banking department. Through the firm's branch offices, which are part of the Retail Sales

Organization, its investment executives handle transactions on behalf of the firm's public customers. Shearson's investment executives are permitted to solicit purchases and sales of securities on the basis of their own analysis of publicly available information. The Retail Sales Organization of the firm may also recommend the purchase, sale, or retention of a security; but all recommendations by the firm are contained in its Master Buy List. Pursuant to its internal policies and procedures, the firm never recommends the securities of an investment banking client. [Bogardus Aff. para. 10, JA at A-28].

In October of 1971, Shearson became investment banker for Tidal Marine; and members of its Corporate Finance Department subsequently worked closely with company officers. Pursuant to Shearson's policy prohibiting the recommendation of securities issued by investment banking clients, the firm never recommended Tidal Marine and did not put it on the Master Buy List. All written material relating to Tidal Marine bore legends similar to the following:

> Attention is called to the fact that Shearson, Hammill & Co. Incorporated is acting as financial advisor in connection with the private placement of securities of Tidal Marine International Corp. and maintains a trading market in the stock. This wire should not be construed as an endorsement or recommendation of the Company's securities. [Bogardus Aff., Exhibit "C", JA at A-37].

Acting individually on the basis of extremely favorable public information, some of Shearson's investment executives suggested the purchase of Tidal stock to various customers, including the two plaintiffs. [Bogardus Aff. para. 26, JA at A-31-A-32; Peress Aff. paras. 5 and 9, JA at A-42-A-43]. Plaintiff-appellee Odette purchased 200 shares of Tidal common stock on February 11, 1972; plain-

tiff-appellee Slade purchased the same number of shares on April 14, 1972.

Shearson received no material adverse information about Tidal until May of 1972, several weeks after the last of plaintiffs' purchases. At this time the investment banking department learned that Tidal was suffering a short-term cash shortage. [Bogardus Aff. para. 18, JA at A-29-A-30]. Pursuant to its policy of confining nonpublic information about investment banking clients to its Corporate Finance Department, Shearson did not disclose the information to its retail sales force, its customers, or the investing public. [Bogardus Aff. paras. 13, 18 and 26, JA at A-29-A-30].

During June and July of 1972, Tidal negotiated with its lenders in an effort to restructure the company's debt obligations. As time passed and no solution was arranged, Shearson encouraged Tidal to disclose its cash shortage and the continuing negotiations to the public. By the latter part of July, 1972, the company had still reached no agreement with its bankers but refused to make any disclosure to the public. [Bogardus Aff. paras. 17-21, JA at A-29-A-30]. Finally, Shearson advised Tidal that, if it failed to make public disclosure, Shearson would report the cash shortage and the loan negotiations to the appropriate regulatory agencies. [Bogardus Aff. paras. 21-22, JA at A-30]. Shortly afterward, on August 1, 1972, Tidal's financial difficulties were reported to the Securities and Exchange Commission. Tidal then issued a public statement disclosing the cash shortage, the negotiations with its lenders, and its unaudited earnings for the first quarter of 1972. Approximately one week after Tidal issued the press release, Shearson terminated its investment banking relationship with the company. [Bogardus Aff. paras. 23-24, JA at A-30-A-31].

ARGUMENT

This appeal presents a single question of law relating to the duty of a securities firm whose investment banking

department acquires material nonpublic information through an investment banking relationship. The existing case law prohibits an investment banker from giving information about a corporate client to anyone or from using it for any purpose other than investment banking until the information has been disclosed to and assimilated by the investing public.

The prohibition against the use of nonpublic information protects the integrity of the marketplace by assuring that all investors will undertake their securities transactions on the same terms. Specifically, the federal securities laws require that all persons in the marketplace have access to the same information. The market in any security is composed of purchasers, sellers, and those who abstain for the moment from purchasing or selling. Taken together, these three factors create the balance which is reflected by the price of the security at any given time. If any one of these groups is modified, *e.g.*, if one segment of purchasers is eliminated, the market in the security will be altered; and all transactions by others will be affected. If that segment of purchasers is eliminated on the basis of information not known to others in the market, that group has received an unfair advantage over other investors; the altered market in which the others continue to deal will be unfairly derived; and some persons who desire to sell will be forced to dispose of their securities at a lower price or may be deprived of any opportunity to sell at all. This is precisely the kind of unfair market prevented by the rules restricting the use of nonpublic information.

The district court held that a securities firm which provides both investment banking services for corporate clients and broker-dealer services for public customers must use nonpublic, investment banking information for the benefit of its public customers under certain circumstances. In making that decision, the court rejected authorities which flatly require the isolation of nonpublic information to the

performance of investment banking activities and relied entirely on a single quotation, in fact, a single word, from *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971), *reh. denied,* 404 U.S. 1064 (1972). Because both the quotation and the word applied to facts materially different from those at hand, they do not govern the present dispute. This issue is considered in Point I, *infra.*

As its underlying rationale for this result, the lower court also held that Shearson had fiduciary duties to both its investment banking client and its customers, that any conflict between these duties was chargeable to Shearson, and that Shearson should bear the liability for loss sustained by the customer as a result of its duty to the investment banking client. All the cases, however, flatly hold that no fiduciary duty to a public customer is a justification for violating the law by misusing nonpublic information. This issue is discussed in Point II, *infra.*

POINT I

Shearson Was Prohibited From Using Nonpublic Information For The Benefit Of Its Customers.

An investment banker or other person having material nonpublic information may not use that information in any manner to assist others in determining whether or not to effect securities transactions. *SEC* v. *Texas Gulf Sulphur Co., supra; SEC* v. *Lum's Inc., et al.,* CCH Fed. Sec. L. Rptr. ¶93,659 (at 93,946-47), ¶94,134 (at 94,567-68) (1972-73, 1973 Transfer Binders) (S.D.N.Y. 1972, 1973); *SEC* v. *Liggett & Myers, Inc., et al.,* CCH Fed. Sec. L. Rptr. ¶94,204 (at 94,869-70) (1973 Transfer Binder) (S.D.N.Y. 1973); *SEC* v. *Faberge, Inc.,* CCH Fed. Sec. L. Rptr ¶79,378 (at 83,105-06) (1973 Transfer Binder) (1973); *In re Merrill*

Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 34-849, CCH Fed. Sec. L. Reptr. ¶77,629 (Exhibit "A") (1967-69 Transfer Binder) (November 25, 1968); *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912, 916 (1961); *In the Matter of Investors Management Co., Inc., et al.*, Securities Exchange Act Release No. 9267, CCH Fed. Sec. L. Rptr. ¶78,163 (1970-71 Transfer Binder) (July 29, 1971); Complaint, *SEC* v. *Bausch & Lomb, Inc., et al.*, 73 Civ. 2458 (S.D.N.Y. 1973); Securities and Exchange Commission, 5 *Institutional Investors Study* 2534-40 (1971); Cook, The SEC and Banks, 89 *Banking L.J.* 499, 510 (1972); Gillis, Inside Information: Are Guidelines Possible?, *Financial Analysts Journal* at 88 (May-June 1974); Ruder, Securities Law Risks in Trust Portfolio Management, 112 *Trusts & Estates* 36, 38 (1973); Eisenberg, Conflicts of Interest and the Regulations of Securities, 28 *Bus. Law.* 545, 548 (1973); and Denworth, in The Loan Officer and Conflicts of Interest, 51 *J. Commer. Bk. Lending* 3, 9 (1969). These authorities define the unanimous position taken by both the courts and the Securities and Exchange Commission on the interaction of a securities firm's investment banking and retail sales departments.

In the *Texas Gulf Sulphur* case, *supra,* this Court stated the basic principles governing the use of material, non-public information under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 as follows:

> "Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934.... By that Act, Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges, ... *the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material in-*

formation...." [401 F. 2d at 847-48, citations omitted, emphasis supplied].

In the *Merrill Lynch* proceeding, *supra,* members of Merrill Lynch's investment banking department learned adverse material information about Douglas Aircraft in the course of performing their underwriting duties and then gave that information to members of the firm's retail sales organization. As part of the final judgment in that proceeding, the Securities and Exchange Commission required Merrill Lynch to adopt a Statement of Policy, which was intended to prevent similar violations by precluding the firm's investment banking department from giving nonpublic information to any persons other than those necessary for the performance of the firm's investment banking duties. The Statement of Policy reads in relevant part as follows:

> "Material information obtained from a corporation by the Underwriting Division in connection with the consideration or negotiation of a public or private offering of its securities and which has not been disclosed by the corporation to the investing public, *and conclusions based thereon, shall not be disclosed by any member of the Underwriting Division to anyone outside the Division except to*
>
> (a) senior executives of the firm and its Legal Department;
>
> (b) lawyers, accountants and other persons directly involved with the underwriters in connection with the proposed offering;
>
> (c) appropriate personnel of the Research Division whose views in connection with the proposed offering are to be sought by the Underwriting Division; and
>
> (d) members of the buying departments of other firms who are prospective members of the

underwriting group for the purpose of enabling such other firms to decide whether, the extent to which or the price at which, they will participate in the proposed offering.

Any employee of the firm who receives such information pursuant to the foregoing shall not disclose such information or any conclusions based thereon except as provided above for members of the Underwriting Division." [CCH Fed. Sec. L. Rep. ¶ 77,629 at 83,351, emphasis supplied].

This Statement of Policy plainly prohibits the use of information acquired by the investment banking department for any purposes other than investment banking functions. Even those members of the Research Division who could receive the information under subparagraph (c) were precluded from using it for *any* purpose other than underwriting work. The prohibition against use includes disclosure of any conclusions based on that information, *e.g.*, the issuer's securities should not be purchased. The Commission did not solve the problem of investment banking and brokerage activities under one roof by imposing a duty on one department to disclose to the other. Instead, it confined the nonpublic information to those who needed it in the investment banking function.

In *SEC* v. *Bausch & Lomb, Inc., et al., supra,* (Complaint filed June 4, 1973) the Commission has sought an injunction against a number of defendants, including Faulkner, Dawkins & Sullivan, Inc. ("FDS"), a securities firm engaged in investment banking and brokerage activities. This action defines even more precisely the restrictions on an investment banker's use of material nonpublic information. The Complaint alleges that an investment analyst in the employ of FDS learned from the Chairman of Bausch & Lomb's Board of Directors that the company anticipated a sharp reduction in earnings from previously announced estimates. The Commission charges that FDS violated § 10(b) of the

Securities Exchange Act of 1934 and Rule 10b-5 because, on the basis of the adverse nonpublic information, *FDS withdrew its outstanding "buy" recommendation for Bausch & Lomb.* [Complaint, para. 25]. The Commission obviously regards as unlawful both the use of inside information to change an outstanding brokerage recommendation which was based on publicly available information and its use to prevent transactions based on a proper interpretation of the publicly available information. Gillis, Bausch & Lomb and Analytical Judgment, *Financial Analysts Journal* at 10, 13 (May-June 1972).

The parallel to this situation in the cases before this Court is obvious. Based upon publicly available information about Tidal, some of Shearson's investment executives solicited orders for the purchase of Tidal stock. Conceding for the sake of argument that Shearson's investment banking department had adverse nonpublic information about Tidal at the time, the import of the Commission's decision in *Merrill Lynch* and its position in *Bausch & Lomb* is clear: Shearson was prohibited from transmitting the inside information received by its Corporate Finance Department to any other person in any form for any reason. Shearson's own brokerage organization was no more entitled to the use of this information than another broker-dealer's retail organization or selected institutional holders of Tidal common stock.

In the *Institutional Investors Study, supra,* the Commission took the position that the federal securities laws prohibited *any* "use by persons having a special relationship with the company of material corporate information that has not yet been publicly disclosed." At 2539-40. The *Study* recommended that integrated financial institutions adopt the following program to prevent abuse of nonpublic information:

> "Institutions must also consider the necessity of segregating information flows arising from a business relationship with a company as distinct from informa-

tion received in an investor or shareholder capacity. Thus, a bank that receives detailed operating information from a company under the terms of a loan agreement may have to prevent that information from being utilized by the bank's trust department; if the information is material and nonpublic, its disclosure to the trust department investment officers might have the effect of contaminating any transactions in the company's stock by the trust department during the period of nondisclosure." [5 *Institutional Investors Study* at 2539].

Banks with commercial loan and trust departments are no different than large securities firms which have investment banking and retail sales departments. Denworth, in The Loan Officer and Conflicts of Interest, *supra* at 8; Yellon, Trust Investments: Problems Regarding Exchange of Information, 54 *Chi. Bar Rec.* 405, 408; and Rosenfeld, Banks and 'Chinese Wall', *New York L.J.*, November 19, 1973 at 1.

In Sandler and Conwill, *Texas Gulf Sulphur;* Reform in the Securities Market Place, 30 Ohio St. L. J. 225 (1969), the commentators considered a hypothetical much like the question at hand: what must a securities firm do when its investment banking department receives nonpublic information contrary to an outstanding firm recommendation? They conclude:

> "... the underlying policy of Rule 10b-5 as construed in *Texas Gulf* is to prevent insiders from taking *any* unfair advantage of their inside knowledge.... [401 F.2d at 854, n. 18.] In this light, the prohibition against insider 'action' must be broadly construed to preclude insiders from, *e.g., foregoing a transaction which they would clearly have engaged in but for their inside information. In the case of brokers or security analysts, their receipt of material undisclosed information should not permit them to withhold a previously*

determined contrary recommendation or to withdraw a pre-existing one.... After such receipt, no investment action should be taken which is not clearly warranted by reference to independent factors.'' [30 *Ohio St. L.J.* at 269-70, emphasis supplied].

The facts in the cases at hand even more strongly required Shearson to remain mute. As a firm, Shearson had taken no position on Tidal securities; hence, it had taken no position inconsistent with the inside information it allegedly discovered. There was no outstanding firm recommendation, only some salesmen soliciting the stock individually.

Shearson's policies were completely consistent with the Commission's position on inside information. A former Chairman of the Commission has said:

> ''A major Commission objective is to eliminate the use of material nonpublic inside information in securities transactions. The *Texas Gulf Sulphur, Merrill Lynch* and *Investors Management* cases are obvious examples of this objective....
>
> ''Some trust officers believe this result presents an almost insoluble dilemma—the inherent conflict between the trust or advisory officer's fiduciary duty to his beneficiaries and his duty to the public. I see no conflict for there is no duty owed to the beneficiary when the trustee violates the law—the only duty is owed to the public. In this context, *banks are no different from brokers* who also have fiduciary responsibilities to their customers. The interests of the general public are singular.
>
> ''Banks should establish *internal procedures to assure that inside information received by one department in the legitimate performance of its banking function is not passed on to another department. A useful guide for preparing such procedures is Exhibit A to*

> *the Commission's decision in the Merrill Lynch proceeding.*" [Cook, *supra,* 89 *Banking L.J.* at 508-10, emphasis supplied].

Thus, plaintiffs' theory of recovery in these actions directly conflicts with the policies recommended by the Commission and followed by Shearson. The firm's policies and procedures prevent its investment executives from formulating investment recommendations on inside information. Plaintiffs would have Shearson utilize nonpublic information to benefit customers by prohibiting securities transactions on the basis of nonpublic information.

The District Court relied entirely on a single quotation from *Texas Gulf Sulphur* which required abstention from "recommending" the purchase of securities prior to disclosure of favorable information; yet it twice conceded that the circumstances in *Texas Gulf Sulphur* varied substantially from the facts at bar. [Mem. Op., p. 6, JA at A-52; Mem. Op. on Cert., pp. 4-5, JA at A-58-A-59]. In *Texas Gulf Sulphur,* various corporate personnel with favorable nonpublic information purchased the company's securities themselves, gave the information to others, or *recommended* to others that they purchase the company's stock. There, the prohibition against "recommending" a security was intended to prevent the use of nonpublic, favorable information for wrongful purposes. That language in the *Texas Gulf Sulphur* opinion prohibited insiders with favorable nonpublic information from using that information to *recommend that others purchase the security.* In the case at hand, individual investment executives also recommended the purchase of stock, but the similarity stops there. Unlike *Texas Gulf Sulphur,* the recommendation was based on favorable *public* information, not on favorable *nonpublic* information.

To comply with the lower courts interpretation of *Texas Gulf Sulphur,* Shearson would have had to act on the non-

public information, *i.e.,* it had to use the information to determine that purchases were not warranted and then to prohibit recommendation of purchases by the individual salesmen. Only after this action in reliance on the inside information could Shearson have returned to a position of complete inaction. In prohibiting solicitations based on inside information, Shearson would have satisfied these plaintiffs but would have violated the rights of purchasers who were not customers to equal information and the right of sellers to a fair market place. Hence, the court below misconstrued the language in *Texas Gulf Sulphur.* Fleischer, Inside Information: How Solid Are "Walls"?, *Institutional Investor* at 31 (May 1974); Gillis, Inside Information: Are Guidelines Possible, *Financial Analysts Journal* at 89 (May-June 1974); Bernstein, Securities—Class Actions, *New York L. J.* at 1, 4 (January 28, 1974); and Harfield, *Texas Gulf Sulphur* and Bank Internal Procedures, 86 *Banking L. J.* 869, 873 (1969).

Shearson complied with the federal securities laws regulating use of inside information. Assuming for the sake of this appeal that Shearson possessed adverse material nonpublic information at the time plaintiffs purchased Tidal securities, the firm could not lawfully have used nonpublic information to prevent those purchases. The decision below holding Shearson liable for policies which further the purposes of Section 10(b) is wrong as a matter of law and should be reversed.

POINT II

No Fiduciary Duty Required Shearson To Use Nonpublic Information For Its Customers.

A securities firm whose investment banking department learns material nonpublic information about an investment banking client has no fiduciary duty to disclose that information to, or use it for, public customers. On the con-

trary, the law requires that the information not be given to or used for the customer until it is available to the public. *SEC* v. *Lum's, Inc., et al.*, CCH Fed. Sec. L. Rptr. ¶ 93,659 (at 92,947) (S.D.N.Y. 1972); *In the Matter of Investors Management Co., Inc., et al.*, Securities Exchange Act Release No. 9267, CCH Fed. Sec. L. Rptr. ¶78,163 (1970-71 Transfer Binder) (July 29, 1971); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Securities Exchange Act Release No. 34-849, CCH Fed. Sec. L. Rptr. ¶ 77,629 (Exhibit "A") (1967-69 Transfer Binder) (1968); Securities and Exchange Commission's Advisory Committee on Broker-Dealer Compliance, *Preliminary Draft—Guide to Broker-Dealer Compliance,* Chapter X at 2 (January 1974); Comptroller of the Currency, Proposed Amend., 12 CFR 9, 39 *Fed. Reg.* 14510 (1974); Interview with SEC Chairman, *Barron's* at 5 (April 9, 1973); Yellon, Trust Investments: Problems Regarding Exchange of Information, 54 *Chicago Bar Rec.* 405, 407 (1973); Cook, The SEC and Banks, 89 *Banking L. J.* 499, 508 (1972); Casey, Speech Before the ABA Section on Corporations, Banking and Business Law, *BNA Sec. Reg, & L. Rptr.* at F-2 (August 16, 1972); Staff Report of the SEC, *The Financial Collapse of the Penn Central Company* 205-06 (1972); and Loomis on Inside Information, *Financial Analysts Journal* at 13, 84 (May-June 1972).

In the *Investors Management* proceeding, *supra,* a number of investment advisors had received adverse material nonpublic information from Merrill Lynch about Douglas. The investment advisors then advised their clients to sell their Douglas securities and immediately sold those securities held by clients in accounts over which they had been granted discretion. The advisors argued that they had a fiduciary duty to their clients to act upon this information. The Commission held them liable for misuse of material nonpublic information, saying:

"We do not find persuasive the claim made by respondents that as persons managing funds of others

they had a fiduciary duty to their clients to sell their Douglas stock upon learning of the poor Douglas earnings, and that a failure to do so might have subjected them to liability for breach of such duty. The obligations of a fiduciary do not include performing an illegal Act, and respondents could have sold the Douglas stock in a legal manner if they had secured the public disclosure of the information by Douglas. And there is no basis for the stated concern that a fiduciary who refrains from acting because he has received what he believes to be restricted information would be held derelict if it should later develop that the information could in fact have been acted upon legally. If that belief is reasonable, his non-action could not be held improper." [CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522.].

Assuming for the sake of argument that Shearson had adverse material nonpublic information at the time when the plaintiff's purchases were solicited, under *Investors Management,* Shearson could not be charged with a fiduciary duty to its public customers to use the information.

In the *Lum's* case, *supra*, Investors Diversified Services ("IDS") settled an injunction proceeding under the federal securities laws by adopting a Statement of Policy required by the Securities and Exchange Commission. The facts in that case are stated at length in the district court's decision on the merits, *SEC* v. *Lum's, Inc.*, CCH Fed. Sec. L. Rep. ¶ 94,134 (1973 Transfer Binder) (S.D.N.Y. 1973). In short, IDS, an investment adviser to several mutual funds which owned Lum's stock, received adverse material, nonpublic information about Lum's. IDS used the information to recommend that all its mutual fund clients sell their holdings. The Statement of Policy adopted by IDS as part of the settlement dealt with this fiduciary responsibility as follows:

"IDS employees have no obligation to the investment companies advised by IDS which requires IDS

> or its employees to trade or recommend trading on the basis of material, nonpublic information in their possession. IDS employees' fiduciary responsibility to the IDS Funds does not require that they disregard the limitations imposed by the Federal securities laws, particularly Rule 10b-5." [CCH Fed. Sec. L. Rep. ¶ 93,569 at 92,947].

IDS had precisely the same relationship to its mutual fund clients that Shearson's account executives had to their customers. Hence, Shearson's account executives could no more properly use nonpublic information than IDS; and Shearson's Corporate Finance Department could not have given it to them for any lawful use.

The impact of *Investors Management* on the question at hand was directly considered by the Chairman of the Securities and Exchange Commission in 1973. In response to an inquiry about the validity of the assertion that a broker violates his fiduciary obligations if he does not use inside information for his customer's benefit, the Chairman responded:

> "Absolutely not. That issue was raised in the *Cady, Roberts* case in 1962. The defendant, which had inside information, maintained it had a fiduciary duty as a trustee of discretionary accounts to act on the inside information and sell the accounts out. We said, no, *there is higher duty to the trading market and the public.*
>
> "The issue was raised again in the *Investors Management* case, where fund advisers were involved. They said they had a fiduciary duty as advisers to get their funds out. We said, no, that has been held to be a violation of the law, and *you have no fiduciary duty to violate the law.* The banks raise this question, too. They often get information from the commercial side of their activities which relates to their pension or trust operations, but *the argument is absolutely legally*

> *unsound.*" [Interview with SEC Chairman, *supra* at 5, emphasis supplied].

If the decision of the district court were correct, the investment banking and broker-dealer functions could no longer be performed by one securities firm. The lower court acknowledged the fundamental restructuring of the securities industry this holding would require when it certified saying:

> "To require organizations like defendant's to refrain from effecting transactions in securities of companies about which they have learned adverse inside information may be to render it exceedingly difficult for any such organization to function as an investment banker for a company and at the same time function as a broker-dealer in that company's securities." [Mem. Op. on Cert., p. 5, JA at A-59].

If the lower court's reliance on fiduciary duties were correct, a securities firm would have to divest either its investment banking or its customer functions or be exposed to civil liability whichever obligation it honored. Rosenfeld, Banks and "Chinese Wall", *New York L.J.* at 1, 3 (November 19, 1973); Herman and Safanda, The Commercial Bank Trust Department and the "Wall", 14 *B.C. Ind. & Commercial L. Rev.* 21 (1972); Lee, Banking Regulation, 26 *Bus. Law.* 139-148 (1970); Whitney, in *First Annual PLI Seminar on Securities Regulation* 351 (1969); and Harfield, *supra* at 873.

The separation of investment banking and broker-dealer functions has been fully considered by the Commission. Securities and Exchange Commission, 1 *Special Study of Securities Markets* 440 (1963). In 1961, the Commission emphatically rejected segregation of the two functions, saying:

> "But segregation as a specific remedy for all the multifarious possibilities for conflicts in the complex secur-

> ities business could not be a simple segregation in any traditional sense but would have to involve fragmentation of the business to a point where (as facetiously pointed out in a recent magazine article) each investor would have his own broker who would not be permitted to act for any other customer or for himself." [1 *Special Study of Securities Markets* 440].

No responsible commentator has advocated total separation. Instead, they suggest the adoption of controls to eliminate the dangers created by potential conflicts. SEC, 1 *Special Study of Securities Markets, supra* at 440; *Report of the President's Commission on Financial Structure & Regulation* 104 (1971); Cook, *supra* at 509; Loomis, in The Loan Officer and Conflicts of Interest, 51 *J. of Commer. Bk. Lending* 3, 6-7, 18 (1969); Bialkin, Conflicts of Interest and the Regulation of Securities, 28 *Bus. Law.* 545 (1973); Schuyler, From *Sulphur* to Surcharge, 67 *Nw. U. L. Rev.* 42, 43 (1972); Herman and Safanda, *supra* at 27, 43; Sandler and Conwill, *supra* at 240; Arnold, Guidelines for the Banker "Insider" or "Tippee", 86 *Banking L. J.* 319, 322-23 (1969); *Report on the Trust Industry by the Corporate Fiduciaries Association of Illinois* at 51-55 (1971); Leiman, in *First Annual PLI Institute, supra* at 323-24; and Harfield, *supra* at 875.

Shearson has sought to avoid this problem by adopting controls. Under its internal policies and procedures, it isolates nonpublic information about investment banking clients in the investment banking department until the information is public. Shearson and its customers would have been far happier had the firm been legally able to utilize inside information to prevent the purchase of Tidal common stock. Shearson, however, could not have undertaken this action because it would have directly contravened both the philosophy and the letter of the federal securities laws. The District Court erred in finding that Shearson breached a duty to its customers by not giving them the benefit of the nonpublic information, and this Court should reverse.

CONCLUSION

The Shearson customers who purchased Tidal securities during the period when Shearson supposedly possessed adverse inside information about the company unfortunately sustained losses, but they suffered no more than they would have if they had been customers of a securities firm with no access to nonpublic information. Reduced to basics, plaintiffs assert that they should have benefited at the expense of other Tidal purchasers not so privileged; but the securities firm and all other with nonpublic information owe their first obligations to the investing public and the market place. The securities firm may not use nonpublic information to benefit its customers by giving new investment advice on a security on the basis of that information.

Rather than use nonpublic information to benefit its customers, Shearson tried to compel "the public disclosure of the information by" Tidal [*Investors Management,* CCH Fed. Sec. L. Rep. ¶78,163 at 80,552]; and it saw that the company's financial difficulties were brought to the attention of the Securities and Exchange Commission when Tidal refused to disclose. This is precisely the course of action prescribed by the Commission for such circumstances. *Investors Management, supra* at 80,552; Interview with SEC Chairman, *supra* at 5; and Yellon, *supra* at 407. A year ago, the Chairman of the Securities and Exchange Commission clearly described the acceptable options available to a financial institution that learns inside information:

> "The institution has a number of alternatives. It can do nothing. It can go to the company and say, look, you have to get a public release out on this over the Dow Jones News Wire. If the company refuses, the institution can go to the Exchange ..." [Interview with SEC Chairman, *supra* at 5].

The Chairman then discussed the relationship between buy recommendations and nonpublic information. If the

securities firm has an outstanding recommendation to buy the stock but concludes on the basis of public information about the company that its earnings will be lower than usual and, therefore, that a buy recommendation is no longer warranted, the firm may withdraw the recommendation. But if the decision to withdraw is based even in small part on nonpublic information, the firm may not withdraw its buy recommendation unless the company in question discloses its projected income. In discussing this precise hypothetical, the Chairman of the Commission said:

> "If you call a company to have it confirm your conclusion, and if the company confirms it selectively to you, that makes it inside information. In that case, you're muzzled and can't act on the information until the company has released it to the public." *Id.*

In these two cases, Shearson complied with the law in every respect. The imposition of civil liability on Shearson for this conduct was error; this Court should reverse.

Respectfully submitted,

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STATUTES AND RULES

SECURITIES EXCHANGE ACT OF 1934

Section 10(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

RULE 10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate, commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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